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September 8, 1994

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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

Mr. William F. Caton  
Acting Secretary  
Federal Communications Commission  
1919 M Street, N.W.  
Washington, D.C. 20554

RE: EX PARTE MEETING ON CC DOCKET NO. 94-1

Dear Mr. Caton:

Pursuant to Section 1.1206 of the Commission's Rules, GTE is filing with the Secretary's office two copies of materials discussed in *ex parte* presentations relating to the above docket on September 8, 1994.

GTE representatives met with Michael Katz, Chief Economist, Office of Plans and Policy, then later with Kathy Levitz, Deputy Chief, Common Carrier Bureau, and Roxanne McElvane, Legal Assistant to the Common Carrier Bureau Chief, to discuss issues relating to CC Docket No. 94-1. GTE discussed points already made on the record in the above proceeding, as well as the attached materials.

Please call me at 463-5293 if you have any questions.

Sincerely,

Edwin J. Shimizu  
Director-Regulatory Matters

**Attachments**

- c: Michael Katz - 1919 M Street, NW - Room 822
- Kathy Levitz - 1919 M Street, NW - Room 500
- Roxanne McElvane - 1919 M Street, NW - Room 500

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### Outline for FCC Ex Parte Discussions

Dr M Schankerman  
London School of Economics  
8 September 1994

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#### Central Objective of Price Cap Reform

- . **Maximum reliance on competitive market price signals to guide entry and investment**
  - . Streamline regulation when competitive discipline exists
  - . Establish pricing and other rules to mimic competitive market until then
- . **Requires "competitor-neutral" rules**
  - . Symmetric regulation avoids "picking winners" in NII investment
  - . Static and dynamic efficiency losses otherwise
- . **Symmetric regulation is only way to ensure efficient development of high quality, market-oriented NII**
  - . Appropriate market-determined technology
  - . Development at minimum cost
    - . Large potential waste if wrong price signals
- . **Key is to establish rules to ensure efficient patterns of competitive entry and investment in future**
  - . Two-stage game: Investment and entry now depend on rules governing post-entry competition
    - . Link between general and transitional issues
  - . Establish competition rules now even if competition is currently limited
  - . Do not delay development of rules until substantial competitive incursion occurs (as AT&T, MCI and Ad Hoc propose)
  - . Need rules that reduce regulation and increase pricing and new service flexibility, conditioned on degree of competition in relevant geographic and product market
    - . Appropriate criteria to assess degree of competition - USTA addressability proposal
- . **Guiding Principles for Reform**
  - . Minimum regulation necessary to address specific issues
  - . Asymmetric regulation only when least costly way in terms of efficiency to redress identified structural or strategic asymmetries

## **Transition Issues**

- . **Framework requires three broad features**
  - . Geographic and product market definition
  - . Criteria to trigger streamlining of regulation
  - . Rules to mimic competition in less competitive areas
- . **Definition of geographic and product markets**
  - . Must reflect either supply or demand substitutability
  - . Narrow geographic markets
    - . Reflects geographic sunkness of facilities
  - . Broad product markets
    - . Reflects service fungibility of facilities
    - . Contestability of services *given the presence of competing facilities*
  - . Not limited to specific access services
  - . Separability of access and local markets
    - . Local number portability and other proposed "preconditions" for access reform
    - . Do not hold access reform hostage to state regulation of local service competition
- . **Rules to mimic competitive markets**
  - . Incremental cost floors
    - . Prevents predatory pricing
      - . Do not adopt broader Ordoover-Saloner definition of predation
    - . Prevents cross subsidisation
      - . Pareto interpretation and net revenue test
      - . Do not adopt fully distributed cost test (in any of its guises such as fixed markups)
  - . Price cap ceilings
    - . Prevents monopoly pricing
  - . Flexibility within these upper and lower bounds
    - . Mimics treatment of common costs under competition
  - . Symmetric treatment of new service pricing
    - . How to define incremental cost with R&D
- . **Tailor regulation to prevent anticompetitive practices**
  - . Preemptive investment
  - . Vertical price squeeze
    - . Remedy 1: Interconnection
      - . Regulatory burden/implementation problems
      - . Efficiency costs with uniform pricing
    - . Remedy 2: Facilities competition (addressability)

- . Predatory pricing
  - . Incremental cost test
- . Cross subsidisation
  - . Net revenue test
  - . "Undue discrimination"
    - . Competitive prices vary both with incremental cost and demand (when there are economies of scale and/or scope)
    - . Efficient pricing requires that demand conditions govern apportionment of common costs
      - . This is not economic discrimination or cross subsidisation
    - . Efficient pricing benefits all customers compared to losing the business to less efficient rival
      - . Comparison to a regulated regime prohibiting competition is not relevant
    - . Fully distributed cost pricing does not generate subsidy free prices
    - . Fully distributed cost pricing creates artificial opportunities for uneconomic entry
    - . Shapley value prices (proposed by NARUC) yields neither constrained welfare maximising (Ramsey) nor subsidy free prices
  - . Nonlinear price designs (demand-related) create consumer benefits, as in interexchange market
- . **Key Elements for Pricing Reform**
  - . Noncompetitive areas: incremental cost test for predation, net revenue test for cross subsidisation, price cap ceilings, and flexibility within upper and lower bounds
  - . Competitive areas: incremental cost test for predation and flexibility above lower bound
    - . Cross subsidisation test not needed because joint costs are across services within geographic market, and competitive entry into services effectively constrains
- . **Criteria to Trigger Streamlining of Regulation: Addressability Proposal**
  - . Criteria for assessing competitive discipline on pricing, not a new economic theory

- . Market power is reflected by incumbent's demand elasticity, which depends partly on cross elasticity of supply
- . Addressability uses *capacity share* as an index of strength of supply cross elasticity
  - . More stringent than contestability
  - . Appropriate if geographic market is narrow and services are contestable given *sunk competing facilities*
  - . One possible solution to vertical price squeeze - alternative to supervised interconnection pricing
- . Involves risk of technical efficiency cost if second facility provider is inefficient
  - . Minimised if rules of competition developed now
- . Concern that capacity threshold for CMA applies to whole wire center and may expose some customers (residential)
  - . Remedy 1: Adjust threshold capacity share
    - . Increases efficiency cost
  - . Remedy 2: Allow only downward not upward flexibility in CMA
    - . Requires continued price cap/regulatory engagement in all CMA markets
  - . Remedy 3: Set capacity threshold separately for business (multiline) and residential customers
- . Focus on capacity share rather than market share
  - . competitive discipline vs outcome of competition
  - . protects competitive process vs competitors
- . Problems with market share criterion
  - . Market share is an outcome of competition, not index of competitive discipline *unless price signals are meaningful*
    - . Meaningful signals requires incumbent pricing flexibility subject to incremental cost
  - . Reserves portion of market for entrants unrelated to relative efficiency - technical efficiency cost
  - . Modern I/O literature focuses on technology, demand, and strategic conduct as determinants of market power and performance
    - . Emphasises endogeneity of market share and concentration - consequences not causes (contrary to Ad Hoc view)
- . Addressability proposal and redefinition of price cap baskets are separable issues

- . **Sharing/Low End Adjustment**
  - . Key to sensible access reform is to condition the streamlining of regulation on degree of competition in relevant markets: Delink pricing in different geographic markets
  - . Sharing/low end mechanisms relink them through need to compute trigger rates of return
- . **Preserve integrity of price cap design**
  - . Maintain reliance on the selected external inflation and productivity (TFP) indices
  - . Do not adjust for cost of capital or any other input prices
    - . Symmetric adjustment for different inputs and for upward/downward movements over time
    - . Virtual cost of service regulation/burdensome
  - . CCL adjustment
    - . Design issue: appropriate productivity offset captures TFP effects of all demand growth
    - . arguments about who stimulated access use are not pertinent, any more than for other dimensions of demand
  - . Consumer productivity dividend
    - . Designed to reflect incentive effect of regulatory regime shift from cost of service, now embodied
- . **Productivity Offset**
  - . Regulatory vs economic depreciation
    - . Economic concept correct to measure TFP
  - . Interstate vs total LEC industry
    - . What is appropriate?
    - . What is feasible?
      - . Illegitimate to adjust output but not inputs (as AT&T does)
      - . TFP measures should not be based on arbitrary fully distributed cost allocations
  - . Input price differential
    - . No statistically significant input price differential, either for the Roddy data or the Christensen data (tested by NERA)
      - . reject Ad Hoc proposals to adopt input price differential and not to use productivity differential
    - . Christensen Tornquist index vs Laspeyres GNPPI - upward bias in measured input price differential

. **Duration of Price Cap Compensation for Productivity Gains**

- . Gains kept by company only so long as it outperforms the target productivity offset - LEC industry differential
  - . Mimics competitive market price adjustment
- . Price cap design features for productivity offset:
  - . Yardstick: averaged over companies
  - . Long term: smoothed over time
  - . Periodic adjustment
    - . Length of averaging and frequency of adjustment are two separate issues
- . How frequently to adjust? Depends on rate at which productivity gains diffuse.
- . For efficiency gains due to new investment, rate of diffusion is directly linked to economic depreciation rate
  - . Explanation: Faster diffusion means reduced quasi-rents on new capital and hence faster economic depreciation
  - . Conclusion: more frequent offset adjustment must be accompanied by faster depreciation
- . Recommend productivity offset be based on BLS industries when available, moving average adjusted automatically at specified intervals
- . Do not adjust on basis of past profitability. Why?
  - . To preserve yardstick incentives and smooth transitory movements, one would have to
    1. Take average over companies and time
    2. Compute an appropriate "normal" rate of return which involves difficult risk comparisons with other industries
    3. Back out an offset that yields this rate of return

More direct and much less problematic to use direct measure of offset from industry TFP data.